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Weekly Macro and Markets View

13 June 2022

Highlights and View

The ECB confirms its intention to hike rates by 25bps in July and signals a likely 50bp hike in September

Hawkish rhetoric by the ECB triggered a sell-off in government bonds and a widening in peripheral spreads, with a lack of clarity on tools to limit fragmentation risk.

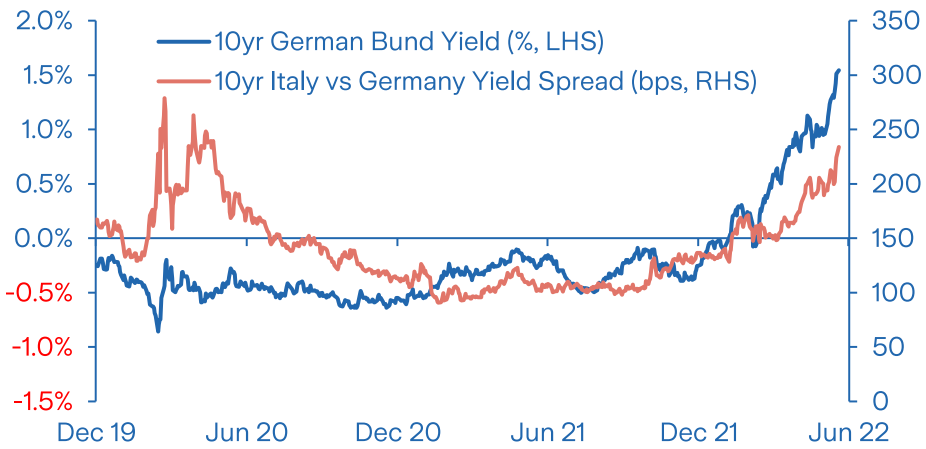
US headline CPI inflation reaccelerates to 8.6% YoY while core CPI slows to 6% YoY

Soaring energy prices were a major driver of headline inflation while the slowdown in core inflation is positive but not enough for the Fed to move away from its hawkish rhetoric.

Boris Johnson survives a confidence vote, though more than 40% of MPs voted against him

Technically, Johnson doesn't have to face another confidence vote for 12 months but the pressure on him is unlikely to abate.

Rise in government bond yields and peripheral spread widening



Source: Bloomberg

The ECB kept rates unchanged in its policy meeting but signalled a steeper rate path ahead. This involves a 25bp rate hike in July to be followed by a 50bp hike in September if the inflation outlook does not improve. Thereafter, gradual but sustained increases should be expected. (Our Topical Thought, *Pressure mounts on the ECB to act*, provides more details on the ECB policy outlook.) The commitment to a 50bp hike was not expected and led to a government bond sell-off, with the 10yr Bund yield breaching 1.5% for the first time since 2014. There was also a lack of details around measures to contain financial conditions in the peripheral Eurozone countries, triggering concerns around fragmentation risk and amplifying upward pressure on borrowing costs. In Italy, the spread on a 10yr government bond vs Germany rose to 225bps, up from 200bps in early June. Peripheral spreads are still contained and below the Covid crisis peak, but peripheral bond yields are the highest since 2014. Treasury yields also rose, boosted by a strong CPI print, with the 10yr above 3.15% by week's end, marking a cycle high. While bond market volatility will remain high until there are clear signs that inflation is peaking, significant policy tightening is now in the price while growth is slowing, which limits the potential for further hawkish surprises and upside to yields.

US

Headline inflation reaches 8.6% YoY while consumer sentiment hits a record low

After a relatively benign start into the week investors' mood increasingly soured over the course of the week following the ECB's hawkish statements and stubbornly high inflation in the US. Headline CPI inflation picked up to 8.6% YoY in May, fueled by soaring energy prices. Meanwhile, core CPI continued to trend lower, slowing to 6.0% YoY from 6.2% the month before. Like in recent months some distortive components, such as a steep rise in airfares, helped to push up service inflation. As expected, however, stickier components keep adding to higher core inflation, particularly rents, which saw the strongest monthly pickup in decades. While the overall slowdown in core inflation is positive, the steady rise in service inflation will get the Fed's attention. Another 50bp hike is expected this week. Rising prices and a deteriorating economic outlook continue to weigh on consumer confidence with the University of Michigan's consumer sentiment survey falling to the lowest on record in June.

China

Compelling economic statistics for May, but...

The worst is over for China's economy, as early economic indicators for May reveal. Export statistics surprised consensus expectations on the upside, up 16.9% YoY vs. 3.9% in April, underpinned by solid breadth in terms of export destinations and product categories. Logistic indicators also recovered and confirm that supply chain issues are easing. As for consumption, spending over the Dragon Boat Festival holidays early this month was far better than during the Labour Day Holidays early May, even though tourist spending still remains about one third below pre-Covid 2019 levels. As new Omicron infections are significantly receding, lockdown measures in Shanghai and Beijing have eased, even though some districts in both cities had to experience renewed restrictions last week. Though we appreciate the evident signs of recovery, we remain cautious about the export outlook, as Western demand for Chinese goods is expected to come under pressure due to shrinking real income. For our view on inflation please refer to our upcoming Q2 Inflation Focus.

LatAm

Inflation risk remains high, but the trend seems to change in Brazil

In Chile, inflation has not yet peaked, hitting 11.5% YoY in May. The central bank hiked the policy rate by 75bps to 9%. The statement mentioned that additional adjustments of smaller magnitudes will be needed for the inflation rate to converge with the target over the policy horizon. Persistently high external costs and more dynamic private consumption led the central bank to a significant review of the inflation forecast for 2022 from 5.6% to 9.9%. In Brazil, headline inflation seems to have peaked, decelerating from 12.1% to 11.7% in May. The positive surprise in food prices and the downward pressure from electricity prices explain the deceleration. However, core and services inflation accelerated, reaching 10.1% and 8%, respectively. The political pressure to reduce inflation has increased, and we expect Congress to approve the bill to cut state VAT. Despite the positive impact on inflation, the bill increases the pressure on fiscal accounts, reducing the attractiveness of the equity market in the short term.

US ABS

Safe haven status remains intact

Spreads across most of the US ABS sectors were flat to marginally tighter for a second consecutive week, outperforming the rest of the credit market. We expect ABS spreads to outperform given their lower rate sensitivity, shorter duration and better credit quality despite broader volatility in markets. Delinquencies have started to rise from the historical lows reached during the pandemic as the impact from extraordinary support measures fades. The deterioration of credit performance was concentrated in the subprime category as lower income households suffered from high inflation. However, lenders remained disciplined and did not relax their credit standards with the average credit score of the borrowers actually continuing to improve slightly in the securitised pools. Furthermore, structural features and pricing of ABS securities should protect investors from losses despite the rise in delinquencies. Given the strength of the US labour market and the structural features backing the senior ABS tranches, we expect ABS securities to benefit from a safe haven status within credit.

Credit

Despite broader angst, leveraged credit sends benign signals

Credit markets were relatively calm over the last week, especially when compared to the volatility in stocks. However, Friday's high inflation reading in the US caused spreads to widen notably, but still in a more orderly fashion than the drop in stocks. Encouragingly, USD High Yield (HY) issuance continued to be brisk, with more than USD 3bn in weekly sales. Moreover, inflows into USD HY funds, despite slowing versus the exceptional USD 4.77bn of the previous week, were still a healthy USD 1.34bn. Therefore, we believe credit markets continue to tentatively suggest a turn in sentiment. This has also been visible in the US leveraged loans market, where the recent gains in loan prices have prompted more companies to issue debt. It will be worth watching how investors receive a USD 1.5bn deal this week from packaging company Intertape Polymer, also expected to price USD 400mn of HY bonds. If the deal goes through, it will be the first CCC rated bond to be priced in six weeks and the first to fund a leveraged buyout in two months. This will be a further test of market appetite.

What to Watch

- In the US, producer prices will give important insights into the amount of price pressure in the pipeline while retail sales are likely to reflect the more cautious mood of households.
- We expect the SNB to raise the inflation forecast for Switzerland and signal a more hawkish stance at its policy meeting, but leave rates on hold for now.
- In APAC, we expect the Bank of Japan to keep monetary policy unchanged, while Taiwan's CBC is likely to hike its policy rate by 12.5bps. China will publish its remaining May activity data while May export data will be released in Japan, Indonesia, Malaysia, and Singapore.

Disclaimer and cautionary statement

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